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Pro rata stock distributions to shareholders

United States. Securities and Exchange Commission

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SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

SECURITIES ACT OF 1933
Release No. 5255

SECURITIES EXCHANGE ACT OF 1934
Release No. 9618

PUBLIC UTILITY HOLDING COMPANY ACT OF 1935
Release No. 17583

INVESTMENT COMPANY ACT OF 1940
Release No. 7204

ACCOUNTING SERIES
Release No. 124

Pro Rata Stock Distributions to Shareholders

Several instances have come to the attention of the Commission in which registrants have made pro rata stock distributions which were misleading. These situations arise particularly when a registrant makes distributions at a time when its retained earnings or its current earnings are substantially less than the fair value of the shares distributed. Under present generally accepted accounting rules, if the ratio of distribution is less than 25 percent of shares of the same class outstanding, the fair value of the shares issued must be transferred from retained earnings to other capital accounts. Failure to make this transfer in connection with a distribution or making a distribution in the absence of retained or current earnings is evidence of a misleading practice. Distributions of over 25 percent (which do not normally call for transfers of fair value) may also lend themselves to such an interpretation if they appear to be part of a program of recurring distributions designed to mislead shareholders.

It has long been recognized that no income accrues to the shareholder as a result of such stock distributions or dividends, nor is there any change in either the corporate assets or the shareholders' interests therein. However, it is also recognized that many recipients of such stock distributions, which are called or otherwise characterized as dividends, consider them to be distributions of corporate earnings equivalent to the fair value of the additional shares received. In recognition of these circumstances, the American Institute of Certified Public Accountants has specified in Accounting Research Bulletin No. 43, Chapter 7, paragraph 10, that "...the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount

equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions." Both the New York and American Stock Exchanges require adherence to this policy by their listed companies. 1/

The Commission also considers that if such stock distributions are not accounted for in this manner the shareholders may be misled. In a recent stop order proceeding 2/ the Commission found that a registration statement was materially misleading because a series of four stock distributions made between 1966 and 1968 "...were 'part of a frequent recurrence of issuances of shares'...[and]...under generally accepted accounting principles they should have been accounted for as stock dividends."

If, in addition to failing to account for the distribution properly, the registrant does not have sufficient retained earnings or current income to cover the appropriate transfer to permanent capital, a question immediately arises whether these factors may be part of a manipulative or fraudulent scheme, and as such are proscribed under Rule 10b-5 of the Securities Exchange Act of 1934. The Commission has stated in published opinions, 3/ in situations where companies did not have retained or current earnings, that the declaration of a dividend not warranted by the business condition of a company is characteristic of a manipulative scheme.

The Commission emphasizes that it will deem the types of transactions noted above to be misleading if the accounting is improper or disclosure is inadequate, and if there is a question of whether the condition of the business warrants the distribution, a further investigation will be considered to determine whether such distribution may be part of a manipulative or fraudulent scheme.

By the Commission.

Ronald F. Hunt
Secretary

1/ See New York Stock Exchange Manual, page A-235, and American Stock Exchange Guide, ¶10,046.

2/ Monmouth Capital Corporation, Securities Act Release No. 5169 (July 14, 1971).

3/ Gob Shops of America, Inc., 39 S.E.C. 92 (1959); Mac Robbins & Co., Inc., 41 S.E.C. 116 (1962).